

some of those profits to the parent as a royalty (e.g., in exchange for the licensing of the parent's name and logo) would be deductible to the subsidiary and tax-free to the parent. From a practical perspective, however, parent tax-exempt organizations generally insist on holding more than 50% of their subsidiaries' stock, (and the new anti-avoidance constructive ownership rules make prior options, such as second-tier subsidiary ownership, no longer available).

B. RELATED FOUNDATIONS OF 501(c)(6) ASSOCIATIONS

1. Overview

"Related foundation" is a term typically used to describe an educational, research, or charitable foundation—tax-exempt under Section 501(c)(3) of the Code—that has some affiliation with a trade or professional association, generally through a shared name or acronym, overlapping boards of directors, power to appoint directors, shared office space and employees, and the like. The reason trade and professional associations establish related foundations is to avail themselves of certain advantages available exclusively to 501(c)(3) organizations:

Only 501(c)(3) organizations are eligible to receive tax-deductible charitable contributions; receive many federal and state government grants; receive grants from private foundations without the foundation having to exercise "expenditure responsibility" (thereby facilitating significantly the ability to receive such grants); and qualify for nonprofit postal permits (enabling utilization of significantly reduced nonprofit postal rates). Organizations tax-exempt under Section 501(c)(6), on the other hand, can receive dues or other payments that will be deductible to the payor only if they serve a business purpose of the payor. In addition, only 501(c)(3) organizations:

- are eligible for many state and local sales and use, real estate, and other tax exemptions (in many jurisdictions, only certain categories of 501(c)(3) organizations are eligible for certain state and local tax exemptions);
- eligible to issue tax-exempt bonds (providing for significantly lower financing costs);
- eligible to receive tax-deductible gifts of property;
- able to commence a deferred giving program with the ability to enter into charitable remainder gift arrangements, provide charitable gift annuities, and have a pooled income fund; and
- able to maintain a charitable bequest program for federal gift and estate tax purposes (whereby individuals are encouraged and enabled to make some provision for support of the organization as part of their estate plan).

The funds raised by a related foundation must be used for educational, charitable, or scientific purposes, but very often, the parent association is already carrying on significant educational, charitable, or scientific activities that

can be shifted to the related foundation. To qualify for tax exemption as a 501(c)(3) organization, the related foundation must be organized principally for educational, charitable, and/or scientific purposes.

A related foundation may engage in many activities that benefit the industry or profession represented by the parent association, including publishing, seminars and conferences, research, grant making, scholarships, fellowships, and awards, among other activities. The related foundation's activities can be funded by gifts, grants, and program service revenue (e.g., publication sales, conference registration fees), leaving the association's revenues (e.g., membership dues) to support the remaining association activities.

It is important to note that educational activities need not be educational to the entire public; they can educate a special segment of the public, such as members of a particular trade or profession. However, the educational programs carried on by the related foundation cannot be limited to members of the parent association (the programs can focus on the interests of such members, but access cannot be restricted to association members).

2. The Operational Relationship

As with any relationship an association maintains with an affiliated entity, strict financial, management, and operational separation must be maintained between an association and its related foundation at all times. This should start, as should all relationships between associations and affiliated entities, with a written affiliation that codifies the relationship between the two organizations. Such a document can and should provide a blueprint for the association and foundation staff and leadership to follow to maintain the requisite separation. It also will serve as the first line of defense in the event the separate corporate existence of the organizations is challenged by the IRS or in court. (See Model Affiliation Agreement Between Association and Related Foundation in Appendix E.)

The separate corporate existence of the related foundation will be disregarded by the IRS or the courts—with tremendous adverse consequences for the association, foundation, and foundation donors—if the parent association controls the affairs of the related foundation so pervasively that the foundation becomes a “mere instrumentality” of the parent. This will occur if “the facts provide clear and convincing evidence that the [foundation] is in reality an arm, agent, or integral part of the parent [association].” IRS rulings and court cases in this area also indicate that no one factor determines whether an affiliated entity will be respected as separate. Instead, the IRS and the courts will consider several different factors and reach a conclusion based on their significance taken together. These include whether a valid purpose exists for forming the affiliated entity; whether the parent is involved in the day-to-day management of the affiliate's affairs; the extent to which the two entities share directors, officers and/or employees; and the extent to which the two entities share facilities and/or services.

However, unlike an association's relationship with a taxable subsidiary or other types of affiliated entities, when the affiliated organization (i.e., related foundation) is considered a “supporting organization” under the Code (which

most are, or should be), more control by the parent association is not only permitted, but is required. In practical terms, while this does not obviate the need to maintain strict financial and operational separation between the entities, more overlap between directors and officers, for instance, is permitted. As the Code requires (in the case of a supporting organization) that the related foundation be "operated, supervised or controlled by or in connection with" the parent association, the IRS cannot credibly contest the presence of some common directors and officers. Nonetheless, this is a narrow and often ambiguous line that must be carefully negotiated.

Parent Association Liabilities

In addition to the mere instrumentality doctrine whereby the parent association may be held responsible for all of the actions of its related foundation due to the exercise of excessive parental control over the foundation, a parent association also can be held responsible for a particular policy or activity of its related foundation if the parent itself participates in the development or execution of such policy or activity. The parent association's liability generally will depend upon the extent of its participation in the policy or activity. In this circumstance, the mere instrumentality rule is unnecessary. The parent association will be held responsible for its own participation and the consequences of such participation. This principle has general applicability to association relations with any separate entity, whether or not affiliated or otherwise related.

3. Association Contributions to the Related Foundation

As a general rule, a parent association may make virtually unlimited contributions—without receiving anything in return—of cash, assets, services, and other items of value to its related foundation without jeopardizing its tax-exempt status or that of the foundation (although the more frequently this occurs, the greater the risk that the separate corporate existence of the foundation will be disregarded). This is because, in most cases, the activities of the related foundation are also in furtherance of the tax-exempt purposes of the association (e.g., educational programming, publishing, research, grants, etc. that are directed at and benefit the members of the industry represented by the association), so the contributions to the foundation advance the association's tax-exempt purposes.

Consequently, while associations generally should transact all business with their related foundations at arm's length and fair market value (to maintain the separateness of the two entities), it is permissible for the association to make occasional infusions of cash, assets, services, etc. to its related foundation, and it is equally permissible for the related foundation to accept such contributions without providing anything in return.

4. Foundation Contributions to the Parent Association

In contrast to the great latitude permitted regarding association contributions to their related foundations, the opposite is true with regard to foundation con-

tributions to their parent associations. Here, as the conditions of tax exemption of 501(c)(3) organizations are much more stringent and limited than those of 501(c)(6) organizations, items of value can only flow from related foundations to parent associations if done in conformance with strict guidelines.

It is permissible for a related foundation to transfer items of value to its parent association in exchange for consideration at fair market value and on arm's length terms. For example, if a foundation owns its headquarters building and leases space in the building to its parent association at fair market rent, there is no problem. A problem arises, however, when the foundation seeks to transfer items of value to its parent association without receiving anything in return, or receiving consideration at less than fair market value. In addition, IRS officials have indicated publicly that the new "intermediate sanctions" law (see Section VII.B.1.) may be applied to transfers of items of value from related foundations to their parent associations when less than fair market consideration is received in return.

A related foundation may properly make grants, make contributions in the form of educational seminars and publications, and otherwise transfer its assets to its parent association without adequate consideration only if it can be clearly demonstrated that such transfers are strictly for one or more qualifying educational, charitable, or scientific purposes. In other words, use of the transferred items must be restricted for specific educational, charitable, or scientific purposes, and the foundation must retain ultimate control and discretion over use of the items. Strict accounting procedures should be maintained to ensure that the items are not used by the association to defray its general operating costs.

It is thus permissible for a related foundation to carry out its educational purposes in conjunction with the activities of its parent association. For example, the foundation and association may jointly sponsor and fund educational programs, or the foundation may sponsor and fund educational programs in conjunction with professional activities of the association (such as educational seminars at the association's annual meeting). The foundation bears the burden, however, of being able to prove that its funds and resources were used solely for the educational programs, and not to carry out professional or business activities of the association. Furthermore, it is critical that the educational programs be promoted and open to all members of the relevant trade or profession (not merely those who are members of the association), and that the foundation's name be clearly and conspicuously used in conjunction with the promotion and staging of the educational programs (not merely the name of the association). Furthermore, if the foundation's nonprofit postal permit is being used to mail promotional materials for the educational programs, it must ensure that the postal permit is not at all being used to promote the professional or business activities of the association (but only the educational programs of the foundation).

Finally, educational programs or materials often are offered by a related foundation and are promoted to, among others, members of the parent association. Moreover, the foundation often will seek to offer discounts to the association's members on such programs and materials. As a general rule, a discount

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to association members on programs and materials offered by the foundation would be seen as a transfer of assets from the foundation to the association without consideration, and would be prohibited. However, most organizations avoid this result by having the association provide something of comparable value to the foundation in return for the foundation offering discounts to association members. For example, many associations permit their related foundations to utilize their membership mailing list to promote educational programs and materials in return for the foundation providing discounts on such educational programs and materials to association members. Alternatively, the association may consider donating other goods or services, such as the use of trademarks and logos, staff services, or even cash to the foundation, in return for member discounts. Regardless of the approach used, the association must always provide something of comparable value to the foundation in exchange for member discounts.

C. POLITICAL ACTION COMMITTEES (PACs)

The nature and extent of allowable trade and professional association participation in the federal election process is governed by both federal election and tax laws. Code Section 527(f) imposes a tax (at the highest corporate rate, currently 35%) on any direct political expenditures (called exempt function expenditures) of a 501(c)(6) organization. Exempt function expenditures are defined as those expenditures made for the purpose of "influencing or attempting to influence the selection, nomination, election, or appointment of any individual to any federal, state, or local public office, or office of a political organization, or the election of Presidential or Vice Presidential electors, whether or not the individuals or electors are selected, nominated, elected, or appointed." Moreover, the Federal Election Campaign Act (FECA), enforced by the Federal Election Commission, prohibits corporations, including associations, from making contributions to or expenditures in support of federal candidates for public office. (FECA does not regulate state or local political activity.) A limited exception is provided for partisan political communications made by an association to its members.

Thus, while it is illegal for incorporated associations to use their own funds to make contributions to federal candidates (certain states do permit incorporated associations to use their own funds to contribute to state and local candidates), FECA sanctions the sponsorship by incorporated associations of affiliated (connected) political action committees (also referred to as "separate segregated funds") to solicit funds and make contributions to candidates for federal office.

PACs, which are subject to Code Section 527 and are referred to for tax purposes as "political organizations," are not subject to tax on their exempt function expenditures (as defined above) or their exempt function income. PACs are subject, however, to tax on their nonexempt function expenditures and nonexempt function income, if any. Exempt function income includes all amounts received from the following sources (to the extent they are separately